



TAX EXEMPT AND  
GOVERNMENT ENTITIES  
DIVISION

DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

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Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

Legend:

Foundation =  
Corporation =  
x =

Dear :

This letter is in reference to the letter dated July 22, 2008, from the authorized representative of Foundation. Foundation is requesting a ruling that the debt of a third party oil and gas working interest owner will not constitute acquisition indebtedness of Foundation under section 514 of the Internal Revenue Code (Code) with respect to Foundation's net profits interest royalty that is carved out of the working interest.

Foundation is an organization recognized by the Internal Revenue Service as exempt from federal income tax under section 501(c)(3) of the Code, and is a private foundation within the meaning of section 509(a). Foundation makes grants to other charitable organizations for general charitable purposes.

Corporation is a for-profit company engaged in the business of oil and gas production and development. Foundation states that it and Corporation are not related to each other.

Foundation states that it has negotiated an agreement with Corporation, pursuant to which Corporation will find and acquire the leasehold, or working interest, in oil and gas properties, and carve out and sell to Foundation an 80% net profits interest in the properties acquired. A separate net profits interest will be acquired each time Corporation makes an acquisition. Foundation will be obligated to acquire up to \$x in net profits interests over a three year period.

The Net Profits Agreement between Foundation and Corporation defines the net profits interest as the right to receive an amount of gross production equal to the specified percentage of "net profits," which is defined generally as the excess of gross production revenue over operating and development costs. Foundation, as owner of the net profits interest, is not liable or responsible in any way for any operating costs or liabilities incurred by Corporation or others

attributable to developing, exploring, equipping, owning, operating, and/or maintaining the underlying oil and gas properties, or to storing, handling, treating, or marketing the production therefrom, and is indemnified by Corporation against such liabilities. The net profits interests will be evidenced by a recorded deed.

The Net Profits Agreement states that Corporation will operate and develop the underlying oil and gas properties and market the sale of oil and gas production. Foundation will not have or exercise any rights to manage or control the properties. On a quarterly basis, Corporation will send Foundation a check for its share of the gross production measured by the defined "net profits". Foundation will also receive reports showing how "net profits" were derived and the current oil and gas reserves.

Foundation states that it will pay cash from its existing equity capital and retained earnings to acquire each net profits interest. Foundation will incur no debt to acquire the net profits interests, and does not intend to ever incur any debt. After it makes this capital investment to acquire the net profits interests, Foundation will have no additional costs with respect to the interests (other than typical property and severance taxes assessed against the interests).

Foundation states that Corporation may incur debt for two purposes. Corporation may incur debt in acquiring the properties, and it may incur debt to operate and develop the properties. The debt will be loans from an unrelated bank, and will be evidenced by a promissory note signed by Corporation. The debt typically will be nonrecourse, and the working interest will be pledged to secure the debt. Foundation will not be a party to any agreement with the lending bank, and will not sign or co-sign the note. Foundation will not guarantee or otherwise agree to be responsible for the debt. The net profits interests will not be pledged to secure the debt, as the net profits interest is a separate property right. In the event of default and foreclosure on the debt, the bank will be able to foreclose only on the working interest. That working interest will continue to be burdened by Foundation's net profits interest. Foundation will continue to own its net profits interest, which will continue to be governed by the Net Profits Agreement. In the event the foreclosing bank chooses to sell the working interest, it may exercise a drag-along right to require Foundation to sell its net profits interest at the same time. The proceeds of any such joint sale will be allocated between the net profits interest and the working interest in proportion to their respective fair market values, and none of the proceeds allocable to Foundation's net profits interest will be used to satisfy the debt.

Law:

Section 501(c)(3) of the Code provides the for exemption from federal income tax of organizations organized and operated exclusively for religious, charitable, or educational purposes so long as no part of the organization's net earnings inures to the benefit of any private shareholder or individual.

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations described in section 501(c).

Section 512(a) of the Code provides that except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

Section 512(b)(2) of the Code provides that there shall be excluded from the definition of unrelated business taxable income all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property and all deductions directly connected with such income.

Section 512(b)(4) of the Code provides that notwithstanding sections 512(b)(1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a)(1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a)(2).

Section 514(a) of the Code provides for the inclusion of unrelated debt-financed income in computing under section 512 the unrelated business taxable income for any taxable year.

Section 514(b) of the Code defines the term "debt-financed property" as any property which is held to produce income and with respect to which there is an acquisition indebtedness (as defined in section 514(c)) at any time during the taxable year.

Section 514(c) of the Code defines the term "acquisition indebtedness," with respect to any debt-financed property, as the unpaid amount of (A) the indebtedness incurred by the organization in acquiring or improving such property; (B) the indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement; and (C) the indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonably foreseeable at the time of such acquisition or improvement.

Section 1.512(b)-1(b) of the Income Tax Regulations (regulations) provides that royalties, including overriding royalties, and all deductions directly connected with such income shall be excluded in computing unrelated business taxable income. However, for taxable years beginning after December 31, 1969, certain royalties from and certain deductions in connection with debt-financed property (as defined in section 514(b) of the Code) shall be included in computing unrelated business taxable income. Mineral royalties shall be excluded whether measured by production or by gross or taxable income from the mineral property. However, where an organization owns a working interest in a mineral property, and is not relieved of its share of the development costs by the terms of any agreement with an operator, income received from such an interest shall not be excluded.

Section 1.514(c)-1(a)(1) of the regulations defines "acquisition indebtedness," with respect to debt-financed property, as the outstanding amount of (i) the principal indebtedness incurred by the organization in acquiring or improving such property, (ii) the principal indebtedness incurred before the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement, and (iii) the principal indebtedness incurred after the acquisition or improvement of such property if such indebtedness would not have been incurred but for such acquisition or improvement and the incurrence of such indebtedness was reasonable foreseeable at the time of such acquisition or improvement.

Section 1.514(c)-1(b)(2) of the regulations provides that for purposes of this paragraph, liens similar to mortgages shall be treated as mortgages. A lien is similar to a mortgage if title to property is encumbered by the lien for the benefit of a creditor. Liens similar to mortgages include pledges.

Rev. Rul. 69-179, 1969-1 C.B. 158, states that a royalty interest is a right to a mineral that entitles its owner to a specified fraction of the total production from the property, free of expense of both development and operation. To be a royalty interest, the right to payment must be free of both development and operating costs.

Rev. Rul. 73-541, 1973-2 C.B. 206, holds that a mine owner who was entitled to a fixed share of the mine's net profits, but who was not liable for any exploration, development, or operating expenditures, retained a net profits interest. The mine owner did not operate the mine and was not responsible for the cost of its operation. The revenue ruling classifies the net profits paid as royalty.

Rev. Rul. 76-354, 1976-2 C.B. 179, describes an organization that purchases mineral production payments with borrowed funds. Thus, the organization incurs indebtedness to purchase mineral production payments. The ruling holds that the indebtedness constitutes "acquisition indebtedness" within the meaning of section 514(c) of the Code.

In Kirby Petroleum Co. v. Commissioner of Internal Revenue, 326 U.S. 599, 604-05 (1946), the Supreme Court said that where the payment for the privilege of extraction made to the lessor by the lessee is the portion of "net income" paid under the lease, such payment of "net income" is rent or royalty paid by the lessee for the privilege of extraction.

#### Analysis:

Foundation will not have nor will it exercise any rights to manage or control the oil and gas properties. Rather, Corporation will operate and develop the properties and market the sale of oil and gas production. Foundation and Corporation are not related to each other, so none of Corporation's activities in operation, development, and marketing of oil and gas properties or product can be attributed to Foundation. Additionally, Foundation is not responsible for or liable in any way for the operating costs or liabilities attributable to Corporation's developing, exploring, equipping, owning operating, and/or maintaining the oil and gas properties, or to storing, handling, treating, or marketing the oil and gas. In return for Foundation's capital investments, Corporation will send Foundation checks for its share of the gross production.

Because Foundation is not involved in the working interests of the properties, income from Foundation's investment will constitute a royalty under section 512(b) of the Code.

Foundation will acquire a net profits interest in the leasehold of oil and gas properties acquired by Corporation. Under Rev. Rul. 69-179, supra, Rev. Rul. 73-541, supra, and Kirby Petroleum Co., supra, the net profits paid are considered royalties. Under section 512(b)(2) of the Code and section 1.512(b)-1(b) of the regulations, royalties are excluded from unrelated business taxable income unless connected with debt-financed property. See section 512(b)(4) of the Code and section 1.512(b)-1(b) of the regulations.

Under section 514(b) of the Code, "debt financed property" is property held to produce income with respect to which there is an acquisition indebtedness. To constitute "acquisition indebtedness" under section 514(c) of the Code and section 1.514(c)-1 of the regulations, indebtedness must be incurred by the organization for the purpose of acquiring or improving property that the organization will hold to produce income. See Rev. Rul. 76-354, supra.

For purposes of federal tax law, a net profits interest in a mine, well, or other mineral deposit is considered "property." Foundation will pay cash to acquire its net profits interest. Foundation will incur no debt to acquire its net profits interest. Therefore, there is no acquisition indebtedness with respect to the net profits interest under section 514(c) of the Code, and, consequently, the net profits interest is not debt-financed property under section 514(b).

Even though Corporation will acquire its working interest in the oil and gas properties with borrowed funds, such indebtedness would not be considered acquisition indebtedness with respect to the net profits interest of Foundation. The indebtedness will be incurred by Corporation and not Foundation; further, the indebtedness will be incurred with respect to the working interest and not the net profits interest.

Furthermore, Foundation's net profits interest is not property acquired subject to a mortgage or similar lien under section 514(c)(2) of the Code and section 1.514(c)-1(b)(2) of the regulations because it will not be pledged to secure the debt incurred by Corporation to acquire its working interest. The working interest debt will not create a lien or other burden that encumbers title to the net profits interest for the benefit of a creditor.

Ruling:

Accordingly, based on the facts and circumstances as presented, we rule that debt incurred by Corporation will not constitute "acquisition indebtedness," for purposes of section 514 of the Code, of Foundation with respect to Foundation's net profits interests acquired pursuant to the Net Profits Agreement.

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Any changes that may have a bearing upon Foundation's tax status should be reported to the Service. Because it could help resolve questions concerning Foundation's federal income tax status, this ruling should be kept in

Foundation's permanent records. Pursuant to a Power of Attorney on file in this office, a copy of this letter is being sent to M's authorized representative.

Except as we have specifically ruled herein, we express no opinion as to the consequences of this transaction under the cited provisions or under any other provision of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If Foundation disagrees with our proposed deletions, it should follow the instructions in Notice 437.

This ruling is directed only to the organization that requested it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

If there are any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Enclosure  
Notice 437

Sincerely yours,

Ronald J. Shoemaker  
Manager, Exempt Organizations  
Technical Group 2